Module VIII: Investing in Stocks

Summary: *In this lesson we will discuss some aspects related to investing in stocks. After reviewing this module, you may not be an expert in investing, but you will possess some of the tools necessary to start on the path of investment. Before you begin investing in stocks, you must be prepared to commit a considerable amount of time to understanding your risk tolerance as it relates to investing. You must also be committed to learning about the company or companies in which you are investing. There are many types of stock fundamentals that must be considered when investing. We will briefly explain the most commonly used ratio for judging the price of a stock, but due to the complexity and scope involved, we have included many websites that provide a wealth of information regarding stock valuation. In this module, we will also try to give you an appreciation for some of the risks involved in investing in stocks and offer a few ways to reduce these risks. Finally, we will examine some of the stock purchasing options available to you.*

Understand What You Are Getting Into

Historically, investments in stocks have outperformed all other forms of long-term investments – large company stocks have returned an average of 11% per year since 1926 as compared to long-term treasury bonds that have averaged 5.2% per year over this same period of time. This makes stocks very attractive if you are investing for the long term. Lets begin by defining what a stock is: STOCK IS OWNERSHIP. When you purchase stocks you are buying a share of a company. You own a tiny piece of the company, tying your fate to that of the company, for better or worse. Always remember it is not enough just to buy a stock in a strong company; you must also ensure you are not overpaying and that the price per share is reasonable. Many investors have purchased stock in strong companies and still lost money by paying more for the stock than it was actually worth.

The return on your investment in stocks is based on dividends, appreciation in the stock value, or a combination of both. Dividends are a share of company earnings paid out to stockholders, usually on a quarterly basis. A company's board of directors usually makes the decision on whether dividends will be paid out. Most dividends are paid in cash, but can also be paid in the form of additional shares of stock in the company. Appreciation refers to the increase in the price the market will pay for the stocks you purchased. For example, assume you paid $20 per share for company Y in 1999, and the stock is now trading at $40 per share. Your investment has appreciated by $20 per share; if you were to sell your shares you would make a profit. Conversely, the stock price could also decline to $0 if the company was to go bankrupt and go out of business—many former Internet companies have suffered this fate and taken their shareholders down with them.

Know Yourself

Investing in stocks can be a virtual roller coaster ride. Your stock value can rise astronomically or it can fall abysmally. You need to truly understand your individual risk tolerance level before investing. Many financial websites have online assessments you can take to determine your individual risk tolerance level. Risk in the context of investing means the relative chance that your investments will either increase in value or decrease in value. As an investor in stocks, you face two basic types of risk -- company risk and market risk. We define both types of risk below:

Company Risk –Company risk is the risk that some type of negative event or circumstance related to a specific company will cause its share price to decrease as a result. The good thing about company risk is it can be "diversified" away. What this means is that if you hold enough different stocks across various types of industries, you can wipe away this risk through the diversification you created by owning many different stocks. The theory is that even though one or more of the stocks may be down in price due to factors related to the individual companies themselves, there may be many others in your portfolio that are up in price. Most mutual funds offer immediate diversification because of the number of different types of stocks owned by the fund (please refer to Module VI for more information on investing in mutual funds). Company risk can take many forms, but we only highlight a few examples of company risk shareholders take when investing in individual stocks.

1) Bad product. If the product the company sells turns out to be defective then the company will not make a profit and the price of stock in that company will plummet.

2) Poor management. Even the best product line cannot compensate for incompetent management.

3) Bad timing or bad luck. For example, you may invest in a citrus company and a hurricane wipes out the entire crop, or you invest in a garment company that has to face an embargo against a country from which it imports cloth. In both cases, there is a high probability your stock in the companies will decrease in value.

Market Risk – Market risk is the risk that the stock market in general declines even though the companies you own stock in may be doing well financially. Some examples of what can move an entire market are: world strife, natural disasters, irrational investor behavior, economic downturns, changes in interest rates, etc. When the market is moving up you make money, but when it is falling down you can lose money on your investment. There is no way to avoid or diversify away market risk—this is the true risk associated with investing in the stock market.

Given the risks involved with investing in stocks, it is very important that you know your risk tolerance level. Once you have determined your risk tolerance level you can decide which investment strategy best fits your profile. If you have a high level of risk tolerance, you can feel fairly comfortable investing in aggressive growth stocks or other types of securities that can go up and down like a roller coaster. If your tolerance for risk is low, you may want to invest in more conservative stocks. You might also consider sticking with mutual funds, given all the advantages of investing in them. Regardless of what approach you decide to take, you must build a diversified portfolio of stocks in order to wipe away company risk. What this means is don't put all your eggs in one basket, for example, by only purchasing shares in volatile technology and biotechnology companies. Always spread your investments across various sectors of the economy to ensure you maintain a diversified portfolio.

Another important component to investing in stocks is determining your investment objectives. These objectives determine whether or not investing in the stock market is prudent. Let's say that you are saving to buy a new car within a couple of years. In this case, your objective is to protect your investment against market downturns because you need the money in a relatively short period of time. The recommendation in this case would be to establish a separate bank account, money market, or Certificate of Deposit where money can be set aside for the eventual down payment for the car. On the other hand, if you are investing for your young child's college education or for your retirement, your investment objective involves adopting a long-term strategy, and stocks offer a good option for meeting these types of long-term goals. Generally, the rule of thumb is to not invest money in the stock market that you will need within a three-year period. The longer the time horizon for investing, the more you should lean toward investing in stocks given the historical performance of the stock market.

Know Your Stocks

Stocks are characterized by many different factors to include company size, type of industry, and company mission or objective. In this section we provide brief descriptions of some of the major categories of stocks:

<u>Growth Stocks</u> - as the name implies, these stocks have strong potential for growth because all or most of the profit generated is invested back into the company. The goal is for your investment to appreciate significantly, but the risk involved with these companies is usually greater as well. In this category you may find start-up companies or companies competing within new industries.

<u>Blue-Chip Stocks</u> - these stocks are generally proven performers with a track record of paying dividends and providing some opportunity for growth. Stocks in this category are usually well known because they have been around for a long time, and they are generally industry leaders like General Electric, for example.

<u>Income Stocks</u> - these stocks pay relatively large dividends and are favored by retirees and other investors in need of a high level of income from their stocks. Many different types and sizes of companies can fall into this category, but a good example of an income stock is Phillip Morris.

<u>Cyclical Stocks</u> – these stocks tend to rise and fall with the ups and downs of the economy, prospering when the business cycle is on the upswing, and suffering on the downswing. Auto manufacturers fall into this category.

<u>Defensive Stocks</u> – these types of stocks are generally seen as safe havens from the business cycle; people tend to buy the products these companies produce regardless of whether the economy is doing well or not. In this category you will find companies that produce necessities like

soap, toilet paper, etc. Procter & Gamble is an excellent example of a defensive stock.

<u>Speculative Stocks</u> – these types of stocks are for the true mavericks, the risk here is extremely high, but the potential for superior returns is also great. Making an investment in Yahoo during its infancy offers a good example for this category. Be extremely careful when investing in very small companies offering potential significant returns – the risk associated with these types of stocks often outweighs the potential for profits.

<u>Value Stocks</u> – these stocks are assumed to be selling at a price that is below their true value. The theory is that the market will eventually realize the inherent value of the company and the stock price will increase as a result.

Regardless of which types of stock you choose to invest in, there are a few basic things you should consider before making the investment. You will often hear these referred to as the “fundamentals.” According to Kiplinger Magazine, a widely read financial magazine, fundamentals of a stock include the following: the company’s profitability, the strength of the company’s balance sheet (an accountant’s snapshot of the firm’s accounting value on a particular date), the expertise of the company’s management, and the prospects of the industry the company operates in. One commonly used measure for valuing a company is the Price-earnings Ratio (P/E ratio). This is the most popular measure for valuing a stock. The P/E ratio is calculated by dividing a stock’s price by its earnings per share. For example, if a stock has a P/E ratio of 50 it means that the price of the stock sells for 50 times the value of its earnings per share over a given period of time. Investors use the P/E ratio to determine if the stock is trading at relatively high price or a relatively low price. An important use of the P/E ratio is comparing a company’s P/E ratio against competitors in its industry and type of business. Making a comparison against the industry average provides valuable insights into how the company stacks up against its competition. There are a number of other ratios related to valuation and profitability you should be concerned about, and a visit to the financial websites listed at the end of this module can help you identify and understand them.

Stock Indexes

You have probably heard the terms Dow Jones Industrial Average (DJIA), Standard & Poor's 500 (S&P 500), etc. These are all stock indexes. A stock index is a collection of stocks grouped for a particular reason and used as a barometer to measure the average performance of the stock market or a particular segment of the market. The oldest and perhaps most famous index is the Dow Jones Industrial Average. This index consists of a group of 30 companies chosen to represent various industries and company sizes. Another very popular measure for the stock market as a whole is the S&P 500. This index is made up of 500 well-established companies operating across a number of industries. Most investment professionals use the performance of the S&P 500 as a gauge for determining how well their portfolios perform. It is interesting to note that many professional mutual fund managers fail to beat the performance of the S&P 500 over time.

How To Invest

One very important decision you have to make is how to invest. As we have stressed throughout this module, individual investment is challenging and time consuming, but also can be very rewarding. The problem is that most of us do not have the time required to properly manage our own portfolio of individual stocks, so using a broker may be a good option to consider. When making the decision on whether or not to use a broker, try to consider all factors. Again, the financial websites listed in this module contain invaluable tools to assist you in making this decision. For example, one disadvantage to using brokers is they charge fees and or commissions that will dilute the value of your investment. Some brokers charge as much as 50% of your initial investment, so carefully weigh the costs against the advantages when choosing a broker. Another option is to use one of the many online services available to individual investors for purchasing shares listed on the stock exchanges. The following lists some of the options you can choose for investing in individual stocks:

Direct Purchase Plans (DPP) – this method allows you to buy stock directly from the company itself, without paying a broker's sales commission.

Dividend Re-investment Plans (DRIPS) – this is a company operated investment program. These plans allow dividends on a stock to be automatically reinvested in additional shares of stock, usually without fee, and sometimes even at a discount.

Through a broker - a broker is an individual licensed to trade stocks on the various stock exchanges. There are many different types of brokers offering a broad array of services.

Start or join an investment club - you can achieve some of the benefits that come with large scale investing by pooling resources with friends or relatives, etc. and invest as a collective group.

Whatever the route is that you decide to take, always make sure that you trade with a brokerage that is SIPC (Securities Investor Protection Corporation) insured. When a brokerage firm is closed due to bankruptcy or other financial difficulties, the SIPC steps in as quickly as possible and, within certain limits, works to return to you cash, stock and other securities you had at the firm. Without SIPC, investors at financially troubled brokerage firms might lose their securities or money forever or wait for years while their assets are tied up in court.

Common Pitfalls

Many financial professionals will caution you about the pitfalls of investing in individual stocks, but given their historical performance, stocks are by far the best investment alternative for obtaining long-term growth. The staff at Kiplinger Magazine has developed what they call the "common errors to avoid" when investing. We will only list them here but for a more detailed explanation please visit their website listed below. The common errors are as follows:

1. Not having an investment plan

2. Not taking time to be informed

3. Not checking the quality of advice

4. Investing money that should be set aside for another use

5. Being optimistic at the top and pessimistic at the bottom

6. Buying on the basis of tips or rumors

7. Becoming sentimental about a stock

8. Buying low-priced stocks on the theory that they will show the largest percentage gains

Always remember that potential rewards are tied to the risk you take when making an investment. Most of the time, the larger the potential reward the larger the risk. In this module we have introduced you to some facets related to investing in stocks, but in order to successfully invest it requires an in-depth knowledge of the stock market and the individual companies for which you purchase shares. The best way to begin investing in the stock market is to choose diversified mutual funds and add money on a continual basis each month or pay period. After you become more comfortable with stock market fluctuations and have thoroughly researched individual companies you are interested in investing in, this is the time to start considering investing in individual stocks.

Recommended Websites

General Financial Information:

www.moneycentral.msn.com
www.investorama.com
www.kiplinger.com
www.investools.com
www.fool.com

DRIPs/DSPs:

www.dripcentral.com
www.netstockdirect.com

Research:

www.moningstar.com
www.yahoo.com
www.cnet.com
www.dailystocks.com
www.marketplayer.com
www.quicken.com

www.stockscreener.com